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the Bankruptcy Process

Robert C. Suter

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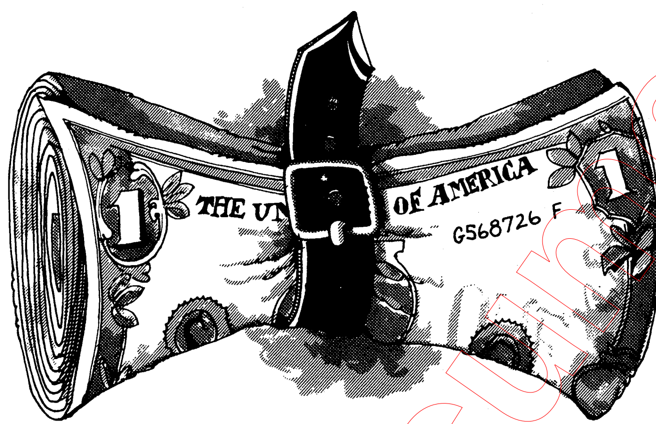

THE BANKRUPTCY PROCESS

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Contents

Summary

Debtors and creditors alike are often unaware of both the law and the procedures involved in a business bankruptcy. This publication outlines the bankruptcy process in general and presents a brief description of each of the three alternatives in the Bankruptcy Code—Chapter 7 (Liquidation), Chapter 13 (Rescheduling of Debt), and Chapter 11 (Business Reorganization).

The Bankruptcy Code was revised in 1978. However, the new code created as many problems as it solved. It has since been declared unconstitutional but as of this date remains uncorrected. As a result there is considerable confusion. This confusion, along with large amounts of procrastination on the part of debtors whose payments are in arrears and of their attorneys, merely further aggravates the problem and reduces the likelihood of a satisfactory solution. Thus creditors have had to assume more and more of the responsibility for getting various cases through the courts.

The final decision in any business reorganization is an economic decision. It is based on one of three considerations:

1. Will the income once again equal the debtor's payments?
2. Is the present value of all assets equal to or larger than the total of the present loan balances plus the interest accruals that are outstanding?
3. Will any further increase in the value of the property occur and to the extent that it will be equal to or greater than all present and future deficiencies?

THE BANKRUPTCY PROCESS

Insolvency and bankruptcy--what conditions lead to these problems? The decline in farm land values; the increase in the cost of various farm resources--seed, fertilizer, herbicides, and particularly interest rates; the changing economic policies of society; and varying degrees of financial mismanagement on the part of a few farmers, are contributing factors. Most important has been the failure of a few farm families to recognize fully the risks related to large amounts of borrowed capital and the quick reversal of the relationship between inflation rates and interest rates.

When an economy is plagued by inflation, leading farm real estate and other resources to increase in value faster than the current rate of interest, it tends to be economically feasible to borrow as much capital as possible with the idea of returning or repaying that money with progressively cheaper dollars in the future. Moreover, once a property owner acquires equity he can decide to "borrow it back," or use that equity as collateral to refinance the existing property and borrow additional amounts to finance additional property. This practice is referred to as "equity leverage." It has had a tendency to lead to "lots of property" but also to a feeling of "false prosperity."

Equity leverage works very well when property values are increasing and when the income stream generated by the property is equal to or greater than the principal and interest payments. However, the strategy is a very daring or dangerous one in that it does not work very well when property values are level or declining or when the cash flow from the business is less than that required to service the debt. If, for example, a property owner has a 35 percent equity in his property and its value declines a third, his liabilities now equal his assets and his net worth is, for all practical purposes, zero. This is known as the "downside risk."

In the long run, any given property or business has to generate enough income to make the principal and interest payments on borrowed monies.[1] When that income stream is not sufficient, and/or when the business is characterized by sizable variations in its income stream, a cash-flow problem can occur. The problem may be temporary, or it can be permanent.

The Debtor-Creditor Relationship: Traditionally, the small-businessman has had the opportunity to borrow sizable amounts of capital at fairly low rates of interest. He who holds prop-

1 The exception is when the property owner has other sources of income.

Acknowledgments are due Professors J. H. Atkinson, C. A. Hurt, and L. F. Schrader of the Department of Agricultural Economics and to Laura Hoelscher of the Agricultural Communication Service. The author is also indebted to a number of other parties including several financial institutions and management consultants who reviewed this publication when in manuscript form and made helpful suggestions, but preferred to remain anonymous.

erty or possesses a potentially successful business can typically borrow to buy real estate, to build improvements, and/or to consolidate debts.

The loan is a temporary transfer of money based on a contractual agreement between the lender and the borrower, obligating each other to fulfill certain legal obligations. The lender agrees to provide a certain amount of money for investment purposes. The borrower agrees to pay certain predetermined amounts (interest) for the use of the borrowed funds and to return the money itself some time in the future.[2] The rules of the game are established prior to the signing of the mortgage papers or security agreement and are typically spelled out in detail. In the event either party fails to fulfill his or her obligations most liens or promissory notes detail the penalties and remedies that are expected.

Most contracts spell out the extent to which any principal payment may be delayed and whether a delay triggers an increase in the rate of interest. Interest paid for the use of the borrowed capital may be compounded, in that additional interest is paid on any interest payment in arrears. When both principal and interest payments are delinquent a contract may call for "acceleration." If so, the remaining payments (or balance) are then due and payable.

Each party entering into this kind of a contractual agreement should be fully aware of the terms of the agreement before they agree to or sign that agreement. However, many borrowers or debtors have a tendency to ignore the more detailed provisions, particularly when the ownership risks appear to be minimal (when property values are increasing). There is a tendency for lenders to do likewise, as the competition for loans increases and as various forms of easy credit are made available.

Both parties are assuming a risk. The creditor's risks lie in assuming that the borrower has certain financial skills, that he has the managerial ability needed to operate his business successfully, and that he has the moral character needed to someday repay the loan on schedule. The more particular lenders appraise the property or security and interview both the farmer-businessman and his wife.

The more capable lenders attempt to answer five questions (not necessarily listed in order of their importance):

1. Is the purpose of the loan a constructive one?

2. What is the value of the security (farm)?

3. What is the earnings capacity of the business, and/or is there income from other sources?

4. What is the borrower's financial history and/or what is his potential?

5. Does the borrower have the ability to manage risk?

6. What about his honesty, integrity, and moral character?

The borrower's risk is primarily one of deciding whether the money being made available to him will increase the profitability of his business. The dollar amount may be insufficient or excessive. Either can be an error. The borrower-debtor needs a farm plan which indicates his intent as well as the profit potential of the business. He needs a cash flow budget which projects all cash farm receipts and cash farm expenses. He should be

2 In the last few years these so-called "predetermined" amounts have sometimes been made "variable." This further complicates the problem.

cognizant of the typical variations in income, the income taxes that have to be paid (assuming the business is profitable), the money needed to support his life style (family living expenses), and the amounts needed to make capital replacements and repay all loans.

There is a third risk for the debtor. During the term of the loan the costs of seed, fertilizer, and other inputs may change, farm product prices may change, and/or land values may rise or fall. The general economy may permit prosperity or impose stagflation. If the farmer makes money, he (and his family) gain financially. If he loses money, both he and his creditor may lose. In other words, the creditor does not gain financially if prices or incomes rise, but both the debtor and creditor can lose if farm prices or incomes fall (and the borrower becomes insolvent). The most a creditor receives is the least he expected--an acceptable return on and of his capital.

<u>Changing Trends in Society</u>: One of the more recent and major difficulties perhaps is that during the last five years society has changed.

Inflation: Ever since the middle 1970's the federal government has generated some fairly sizable deficits. The methods used to finance these deficits resulted in considerable inflation. Not only that, inflation became an acceptable way of life. It was the price one paid for economic progress. Furthermore, society was assured by economists that such inflation would undoubtedly continue to be the modus operandi in the future.

Equity leverage: During the 1970's borrowers and lenders became knowledgeable about, in fact intrigued with, equity leverage. For those persons with a low aversion to risk it was a quick road to riches. Absentee-owner investors (some of them foreign) as well as well-established farmers became interested in buying more and more land. They typically assumed that such could be paid for with cheaper dollars in the future and that almost any land purchase was an excellent hedge against the declining value of the dollar.

Increased land values: During this period the increases in farm land values provided the basis for additional borrowing. The lending institutions, in helping borrowers fill out credit statements, had a tendency to ignore historical costs and substitute instead inflated values. The larger figures made a borrower's credit statement look good. They made the loan decision easier and, indirectly at least, made larger amounts of credit available. A few lenders as well as many borrowers forgot that farm land values could decline as well as rise.

Cash flow vs farm earnings: Many "well-educated" lenders failed to comprehend the difference between short-term cash flow and long-term farm earnings. They required a cash flow equal to or greater than the servicing of the debt. This was no problem. But they inflated farm equities as a result of inflation and ignored farm earnings.[3] When the cost-price relationship then squeezed those farm earnings, land values declined, the number of interested land buyers declined, and the inflated equities evaporated.

3 As long as the farm business generated sufficient cash (to pay the principal and interest payments), there appeared to be no problem. But, that cash is actually a residual amount that remains after the farm operating expenses are paid. It does not include increases in inventories not yet sold, nor does it include increased property values not yet realized.

Interest rate fluctuations: Controlling inflation then became important. In the 1980's the federal government reversed its economic policies. The Federal Reserve System changed from a stable interest rate policy to one of a more stable money supply and allowed interest rates to fluctuate. This caught a number of creditors, as well as their debtors, by surprise. In order to protect themselves, some of the lending institutions shifted to variable rates of interest. Many borrower refinanced their farming operations, but at higher rates of interest.

The lending of money is a serious and competitive business. In the 1970's the typical lender was accused of being too conservative. Today, some of these same lenders are being accused of having been overly aggressive, and of lending too much money, in fact more than any borrower should have accepted.

Financial Difficulty: Statistically, there are very few farmers in financial difficulty. As of the spring of 1983, various lending institutions indicated that 5.0 percent of all farms were in some degree of financial difficulty (causing them to liquidate some of their assets), that some 3.0 percent were delinquent in their payments, and that 1.0 percent were facing foreclosure.[4]

However, these few farmers that entered bankruptcy created considerable concern in their communities. They attracted more than their share of the media's headlines. The impact of a single filing was often greater than the events directly affecting any particular party. When an individual farm family goes bankrupt, the local lending insitution (with a secured loan) does not always receive the value of its collateral. What's worse, the local machinery dealer(with an unsecured loan) often receives but $0.20 or $0.40 on each $1.00 worth of purchased equipment.

Society tends to champion the cause of the little fellow--in this case the debtor. In fact, some members of society have a tendency to look almost with favor upon the man who cannot pay his debts. These persons, as well as the judical system, tend to ignore the original contractual agreement and thus the creditor's interest, particularly if the creditor is a large out-of-town financial institution.

When farmers face financially difficult times there usually arises a demand for a moratorium on foreclosures. A moratorium, like a bankruptcy, provides additional time. It also provides a debtor with the opportunity to dig himself into an even deeper financial hole. Thus, a moratorium is often nothing more than a short-term band-aid type remedy which puts off the inevitable, and further delays any long-term solution.

Definition

The property owner who continues to find himself in financial difficulty may sooner or later face questions of insolvency and then bankruptcy. Hence, the purpose of this publication. The difference between insolvency and bankruptcy is largely a matter of degree. The first usually leads quite rapidly to the second unless some quick remedies are found.

Insolvency: The property owner is insolvent when he is no longer able to pay all cash farm operating expenses

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4 There is one exception. Some 25 to 50 percent of the payments now due the Farmers' Home Administration are delinquent. However, this agency's modus operandi has traditionally required a borrower to demonstrate his inability to acquire credit elsewhere before making him a loan. No wonder the FmHA numbers stand out.

and at the same time have the income needed to pay his income taxes, provide for family living, and repay his debts (in that order). Insolvency is a function of time. An individual who cannot pay his debts on a particular day is not necessarily insolvent. Usually the property owner can reschedule the repayment of his debts, shifting short and intermediate-term debts into long-term financings. Sometimes some of the farm's assets can be sold.[5] But if the proceeds will not "cover" the liabilities then there is no question. The property owner is insolvent.

The farmer may also need to change his life style. But not always is the small-business man or his family willing to do so.

Bankruptcy: Certain laws in this country are designed to provide a debtor who is in financial difficulty with additional time--presumably the amount required to "work out" a solution. The law is also designed to relieve that property-owner debtor of his property if necessary, and to distribute either the property and/or the proceeds for the sale of such, among all creditors. This latter action eliminates any and all further personal liability on the part of the debtor (for his then existing debts). It's called bankruptcy.

In this country the two terms are used in a very broad and general fashion. The distinction between the two appears to be relatively unimportant.[6] Technically, insolvency is a phenomenon that can (or should) be recognized early. The law can then be set in motion at the debtor's request and for the benefit of the debtor. In its more advanced stages insolvency leads to liquidation. The law can now be set in motion at the lender's or creditor's request, and with the remedy designed to help the creditor.[7] Even in the latter instance, however, bankruptcy "helps" the debtor. It discharges his debts and relieves him of all further responsibility in a financially intolerable situation.

Early Problems and Solutions

The person who realizes that he is in financial difficulty should first go to his creditors and seek their advice.[8] If he and his lender (or lenders) cannot work out a solution satisfactory to all parties, he may then go (through an attorney) to a court of equity and petition for an extension of time.

The Rescheduling of Debt: Whenever a borrower cannot meet his principal and interest payments, he may be able to restructure his repayment dates so they will more nearly correspond to the income stream from his business.

5 It takes time to sell property. And, if values are declining and/or if the neighbors and others expect those values to decline, selling is sometimes very difficult. It is very painful to accept the fact that property values have declined since the property was purchased. Failure to accept this economic phenomena speeds the progression from illiquidity to insolvency to liquidation, and often at a most inopportune time.

6 This is direct contrast to England and on the European continent where the distinction between the two is quite apparent.

7 A bankruptcy and a distribution of a debtor's property among all creditors in general is much broader than the remedies that are instigated by an individual complainant relative to extinguishing a contractual agreement or foreclosing on a mortgage.

8 Most persons hesitate to do so--for it is to admit to financial weakness. However, to not do so is a measure of managerial weakness.

He, with the consent of his creditors, may be able to convert short or intermediate-term debt into a longer-term loan, and thus "stretch out" the principal and interest payments. His lender(s) may be willing to extend the term of a loan (for example, from 20 to 30 years), and thus reduce the principal amounts. His lender may be willing to reduce the contract amount (to a more manageable portion) and substitute a balloon payment (sometimes a sizable one) at the end of the contract period. (The borrower pays current interest only on the unamortized amount or balloon.)

In the more difficult situations, one or more principal payments may be skipped, with the debtor paying interest only, and/or an interest payment (or two or three) may be skipped, with the amount(s) being added to the remaining balance of the loan.[9] Most lenders indicate that in many instances these practices merely represent a "band-aid" approach and that they in turn prevent the likelihood of a long-term solution.

Variable Interest Rates: When the risks are high and interest rates are fluctuating, a lending institution may decide to loan money based on variable rather than fixed rates of interest. A lender may decide to make a loan based on a floating rate of interest, for example 2.0 percent above prime. Each of these strategies may provide the property owner with additional money. But they also increase the risk. In many instances, variable rates of interest are a part of the problem rather than a part of the solution.

Interest Accruals: If a borrower does not make certain principal and interest payments on time it is very easy to accumulate interest accruals. The interest rate may then go from a regular to a penalty rate. The interest accruals are then added to the amount of the loan principal, and the problem compounds itself rapidly.

When interest rates were four and five percent (several years ago) there was little or no problem. However, with interest rates of 10, 12, and 16 percent, or, what's worse, two percent above prime, the debtor's financial situation deteriorates rapidly. A "borrower-beware" warning in a financial contract is perhaps similar to the traditional "buyer-beware" cliche in the purchase of property.

The Question of Fraud: A voluntary admission to insolvency or declaration of bankruptcy tends to be viewed as a reflection on a farm family's managerial ability. They indicate some degree of financial mismanagement. No farmer wants to admit to such. Unfortunately, it's easier to ignore the basic problem, go to another lender, and borrow additional money. This may be a mistake.

The debtor who chooses this alternative may, upon occasion, submit misleading or false information. What's worse, he sometimes decides not to disclose all of whatever information may be required or desired by a given lender. He may do so by intent. That, when legally identified, is fraud.

The Family's Life Style: Insolvency and bankruptcy often require a tightening of the purse strings--of both business and family--and along with that, a change in life style. Rather than continue to substitute capital for labor (the traditional direction in farming), one or more labor-consuming farm enterprises may be advisable. The cash-grain farmer, long accustomed to a corn-beans-Vegas rotation, may need to start "mothering" 20 sows. He and his wife may decide that the kids should learn more

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9 The debtor may also reduce his debt by selling some of his assets. This assumes that property values are not declining. See footnote 4.

about raising a garden.

Sometimes the opposite occurs. A borrower who forsees an incurable financial problem sometimes goes on a last minute spending spree using up the remainder of any borrowed funds.

The Bankruptcy Code

The primary laws with regard to insolvency and bankruptcy in this country are now contained in the 1978 Bankruptcy Code. The law was basically designed to provide time to any debtor who needs such to get reorganized financially. With the help of his creditors he may be able to reschedule his debt so that his cash flow is more in line with his ability to pay. The law was also designed to liquidate the debtor's assets, to relieve him of all further responsibilities (to his existing creditor's), and to let him and his family start a new "economic life." However, this latter alternative is to take place only when a given financial situation is presumed to be impossible.

The law was not designed to encourage or allow a debtor to "milk" a given business of inventory or income-producing assets. It was not designed to encourage him to transfer assets or money out of one business entity and into another (for example, a corporation), and it was not designed to provide a debtor with time merely to take unfair advantage of his creditors or commit fraud.

A Chapter 7 Bankruptcy (Liquidation): A chapter 7 or "straight" bankruptcy calls for the liquidation of all assets and the discharge of all debts. It is available to businesses as well as individuals (or consumers) regardless of whether the business is a sole proprietorship, partnership, or corporation.

The straight bankruptcy (Chapter 7) typically commences with the filing of a bankruptcy petition by one of the creditors.[10] But not always. The petition must claim that the debtor is not generally paying his debts as they become due, and that the amounts now due the petitioning creditor (or creditors) exceed the value of any collateral by at least $5,000.

The debtor must answer this petition. Unless he can convince the court that the creditor's allegations are incorrect, the court will accept the petition and enter an order for relief.

A Chapter 13 Bankruptcy (Rescheduling of Debt): A chapter 13 bankruptcy is one which provides a period of time during which all loans or debts of an individual with a regular income can be rescheduled so that the payments are more in line with the debtor's capabilities.

A Chapter 13 is available to any individual and/or to the sole proprietor of a small business whose debts are secured by collateral of less than $350,000 and/or unsecured debts of less than $100,000. It is not available to partnerships or corporations.

It is a fairly advantageous alternative for the farmer or small businessman in that he can, temporarily at least, continue to operate his business. The automatic stay or hold applies only to the debts of an individual; it does not apply to the business operated under a partnership agreement or to the small corporation.

The procedures followed in a Chapter 13 bankruptcy are both simpler and

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10 This assumes there are less than 12 creditors. When there are 12 or more creditors, a petition by three or more of them is required. But as one reviewer pointed out, "A straight court case, foreclosing a loan, is faster, cheaper, and easier."

less expensive than the next alternative--a Chapter 11 business reorganization. Many farmers and small business men exceed the above amounts, and a reorganization plan is thus required.

A Chapter 11 Bankruptcy (Business Reorganization): A chapter 11 bankruptcy is one which places a temporary hold on the repayment of all debts until all parties involved agree to a reorganization of the business. Chapter 11 is available to all businesses as well as individuals. It is the primary type allowing a farmer to reschedule his payments so they are more in line with his cash farm receipts, to perhaps sell some of his assets reducing his liabilities, and in addition, to take the time to develop a new farm plan and project a new or better income stream.[11]

A Chapter 11 bankruptcy is available to either individuals or businesses, and, if the latter, it is available to sole proprietors, partnerships, or corporations. The code envisions a "debtor-in-possession." Hence, the farmer-borrower or debtor can usually continue to manage or operate the farm or ranch business. Yet when it is in the best interest of all creditors, when there is some question as to the debtor's ability or desire to continue, and/or when there is evidence of financial mismanagement, incompetence, dishonesty or fraud, the court may appoint a trustee to take over and operate the business.

The code generally favors the debtor at the expense of the creditor. Most judges, with their typically humanistic approach, also lean over backwards to protect the debtor. Thus creditors have but one alternative. This is to be fully cognizant of their rights and to press for action as soon as and as aggressively as possible.[12]

Involuntary vs Voluntary Petitions: A bankruptcy petition can be filed by either the creditor(s) or the debtor. That petition, from the debtor's standpoint, can be either voluntary or involuntary. With the the voluntary petition, the debtor, realizing he is in financial difficulty, takes the initiative, requesting assistance in rescheduling his debts, in reorganizing his business, or both (This is a Chapter 11 or 13 filing). With the involuntary petition, a creditor (or creditors) forces the debtor into bankruptcy when he has failed to fulfill his previously agreed-to financial obligations. (This is a Chapter 11 or 7 filing.) With one exception the bankruptcy petition may be filed by either the debtor or the creditor(s).

The exception is in agriculture. An involuntary bankruptcy cannot be filed against a farmer by his creditors. Thus, all farmer bankruptcies are voluntary.

The Time Periods: Two time periods immediately become important once the

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11 Chapter 11 in the 1978 Code now covers all business reorganizations. It replaces the previous Code's Chapters 10, 11, and 12.

12 The Code grants broad authority to the bankruptcy court judges, and as a result, the United States Supreme Court on June 28, 1982 held the law to be unconstitutional. This has left the courts in a quandary and many of the debtor's and creditor's stategies in question. The judges rule, but they are not ruling in unison. As a result, the question of jurisdiction can be raised in any court today, and at any stage in the proceedings. This confusion is of little help to either debtors or creditors. It leaves the debtor, his creditor, and most judges who wants to solve these problems in limbo. The Congress was given until December 24, 1982 to correct this problem. But, as of this date (May 1, 1983), the Congress has failed to act.

bankruptcy petition is filed. The debtor has 120 days during which he can work out and/or come forward with a plan for reorganization. He has an exclusive right to file his plan, and after the 120-day period, he has 60 additional days to get his creditors to accept his plan.[13]

If the debtor does not file a plan within the 120-day period and/or if he files a plan which an unhappy creditor will not accept (within the 180-day period), then that creditor, or any other party with an interest, may come forward and file an alternative plan. The plan may be formulated by an individual creditor, a group of creditors, an individual stockholder, or a group of stockholders--any party with an equity interest, or any agent who represents one of these groups. Furthermore, in order to receive approval, any given plan may be revised.

Types and Classes of Creditors: All creditors (usually there are more than a few) are grouped into classes. Each class supposedly holds substantially similar claims. Each class will presumably receive similar if not the same treatment.[14]

1. Some creditors are financially injured or impaired; others are "unimpaired". Creditor(s) are unimpaired if:

a) the plan does not alter the legal, equitable, and contractual rights of any claim in that class, or

b) all defaults are cured and the contractual rights of each claimant are not otherwise altered, or

c) each creditor is paid the amount of his claim.

If a creditor or class of creditors is unimpaired, acceptance of any plan is a foregone conclusion. The acceptance decision is triggered only by the "impaired" creditors.

2. Some creditors hold "secured" interests backed by collateral or property; others hold "unsecured" loans without the debtor's pledge of any assets. A secured creditor is one who has advanced or loaned money to the property owner debtor and has required and received in exchange a lien on some item of property. That lien may be in the form of a mortgage (real estate) or a security agreement (non-real estate). The property involved is referred to as the security or the collateral. The secured creditor is concerned with the return of his money either through continued payments, or if the buyer defaults on his obligations, by foreclosing and selling the property.

An unsecured creditor is one who has advanced or loaned money to the debtor without a lien on any property or without collateral. The debtor may have borrowed on "his name only," in which case the loan may be referred to as a "signature loan." The unsecured creditor has a problem, in that his loan is lower in priority. He also is interested in eventually getting his money, but this has to be accomplished either voluntarily (by reaffirmation or renewal of the loan) or by forced action.

The secured creditor may be under- or over-secured. If partially or under-secured his claim is secured but only up to the dollar value of the

13 In some instances, the two time periods are excessive; in other situations, they are inadequate. For this reason, extensions are often requested and granted. Many extensions are typical. Usually they are the result of procrastination rather than progress. (Reductions may also be requested and granted but seldom does this occur.)

14 An exception occurs if one party is willing to accept a less favorable solution.

collateral. To the extent that his claim exceeds the dollar value of the collateral, his claim is unsecured. If over-secured he is in a unique position as long as the collateral or property does not depreciate or decline in value. However, the over-secured creditor's cushion of equity may shrink (percentagewise), if that debtor is allowed to increase his debt load. There are many instances when a debtor has sold a secured creditor's collateral "outside" the ordinary affairs of his business, without the court's permission, and spent or run off with the money. Hence, even the over-secured creditor has need to pay careful attention to a borrower's activities.

3. Some creditors hold priorities over others. Some come first, for example, the party who holds a first mortgage. Others hold a secondary interest, for example, the party who holds a second, third, or equity mortgage. Furthermore, some creditors' rights to proceed are based on time. The quality of their claim depends on when the loan was made, when the debt was established, or when the lien was perfected.

The Typical Modus Operandi

When a bankruptcy filing is likely or probable, a creditor should review and attempt to perfect any security interest he may hold. If his loan is unsecured he should attempt to get collateralized immediately.[15]

In many instances, a creditor repossesses (or begins to repossess) some or all of the debtor's property without knowing that he is in the process of filing (or has filed) a bankruptcy petition. If there is some question, the creditor should contact the court (talk to the clerk) or call the debtor or his attorney. Once a bankruptcy petition is filed, a secured creditor cannot take any action to repossess and/or foreclose on his collateral.[16] For this reason, many creditors take possession and sell the debtor's property very quickly (sometimes in a matter of a few hours) and before the debtor has the opportunity to file and/or even visit with his attorney.

Once a bankruptcy petition is filed, an "automatic stay" or order for relief takes place. It acts to stop any and all further attempts on the part of the creditors to collect their debts. This provides the debtor with time--time to take inventory, analyze his financial situation, reschedule some or all of his repayments (assuming his creditors are willing), and to perhaps reorganize his farm business.

It is now the debtor's responsibility to disclose his financial affairs, present a financial statement listing all assets and liabilities, and give the court a list of all creditors.

Creditor Strategies: The secured creditor should generally act as soon as possible. He should immediately

15 When a debtor becomes delinquent in his payments (after he defaults and hopefully before the bankruptcy petition is filed) the creditor may ask for and obtain a second, third, or equity mortgage on the debtor's realty. Why? Because a secured creditor's lien is not necessarily extinguished by a bankruptcy petition. (A mortgage recorded within 90 days of a Chapter 11 filing can, at the discretion of the court, be set aside.) The enforcement of the lien and/or all of the creditor's rights are merely delayed until the "automatic stay" or holding period called for by the bankruptcy petition and decreed by the court is "lifted."

16 If repossession of the collateral or property has taken place but such has not been sold, foreclosure cannot be continued.

file a request to "lift the stay." His goal is to get the stay lifted, to repossess or reclaim the property, to force a deadline for action (for example, to get the court to make decisions), and to recover any and all attorney fees and court costs. The typical proceedings take months or years rather than days or weeks. Hence, the sooner the secured creditor indicates his desires and "gets on the record" the sooner the case may be brought to a decision.

A creditor should ask (immediately) to inspect the collateral or property, to be provided with proof that the property taxes have been paid and that the property is also properly insured. If there is some likelihood of unwarranted depreciation or damage to the property which can lead to a reduction in its value, the creditor may request "adequate protection" and/or relief from the "automatic stay."

A creditor should force the debtor (or his trustee) to begin to make regular financial reports, to account for all cash farm receipts and expenses (both projected and real), and to report any irregularities. This information determines if a reorganization is economically feasible or whether a liquidation should commence. All creditors are entitled to this information. The information may also provide evidence relative to the dissipation of the assets and/or fraudulent practices on the part of the debtor. In actual practice this is very difficult to accomplish. Debtors as well as their attorneys often have little expertise in farm accounting. Furthermore, it often appears that they "muddy the waters" by intent.

Unfortunately, the unsecured creditor is not very well protected. In a Chapter 11 case he has but one alternative--to become active on the creditor's committee. He needs the committee and/or a trustee and/or an aggressive attorney to protect his interests.

<u>The First Meeting</u>: Once the petition is filed the court proceeds to a meeting of the debtor (accompanied by his attorney) and all creditors--both secured and unsecured (also accompanied by their attorneys).[17]

The debtor should expect the creditor and/or his legal counsel to ask some hard questions. They will want to know his intentions. They will request an up-to-date inventory and an appraisal of all assets--both real estate and personal property. They will request a detailed accounting of all debts. The latter should include the value of the collateral or property, as well as the terms of the loan--remaining balance, rate of interest, amount of each payment, number of payments remaining, and due dates.

The debtor has several alternatives. He may volunteer to release his collateral or property. He may ask for a reaffirmation and/or a rescheduling of his debts. Or he may refuse to cooperate if he feels that his creditor(s) have taken unfair advantage of him in the past.

The goal (on the part of all parties) is to get the debtor back into an acceptable financial position whereby his debt is in line with his income stream and whereby he can meet his obligations without an adverse affect on his family. In many instances, the debtor has taken on more risks that he can handle and there is

17 A loan officer alone has little impact on a debtor or his attorney, in court or out, unless his boss--the financial institution--also hires legal counsel. The debtor's attorney is generally willing to talk to the creditor's attorney, but he doesn't always return a telephone call to the creditor when the creditor himself is seeking information.

no real solution other than liquidation (Chapter 7).

Any creditor who finds a debtor in arrears is entitled to inquire into the reasons why. If the reasons are not acceptable and/or if it appears that the debtor will continue in arrears, that creditor may "proceed against" the debtor.[18] The same laws apply. First, the debtor is given a certain amount of time to correct his financial difficulties. If a rescheduling of the payments can be worked out it is the duty of the creditor(s) to help in doing so. The arrangement has to be fair to both the secured and unsecured creditors. Second, if it is fairly obvious that the debtor will not make his payments, a creditor is allowed to liquidate some or all of the debtor's property. Either the property or the proceeds from the sale of such is then allocated among all creditors in general. In these instances, the debtor is an involuntary participant. Yet, he gets to have his debts discharged; he is no longer personally liable for them; and he and his family can start "economic life" anew.

<u>The Creditors' Committee:</u> Once a Chapter 11 petition is filed either by the creditor or debtor, the court generally appoints a creditors' committee to supervise the development of a plan for reorganization of the business. That committee consists of the seven largest unsecured creditors willing to serve. Various members of the committee may participate in the reorganization plan. They may consult with the debtor, his attorney, and/or a financial consultant with regard to the farming operations. They may do that as individuals, or they may hire an attorney, an accountant, or a consultant to represent and/or assist them in performing these services.

18 The exception, already noted, is the farmer.

The committee's job is to do whatever is in the best interest of all creditors. Their goal is to provide a fair treatment of all parties, at least that's the theory. However, in actual practice, most unsecured creditors are reluctant to serve. They hesitate to get involved, even if appointed. Oftentimes, they ignore the job and for good reason. Most of them are aware that the probability of an unsecured creditor receiving any benefits is quite low. Most of them realize that they will probably receive only a fraction of the value of any unsecured assets. Most of them feel that there will be little or no return on any further investment and that their time is better spent on some other activities.[19]

The creditor committee members are usually volunteers. Many of them are naive, or they wouldn't volunteer. (That's not the way it is supposed to be; that's the way it is.) The experienced committee usually requests the court to appoint a trustee. This trustee then advises and guides the debtor with regard to all decisions relative to the reorganization of his business.

The committee's and/or trustee's responsibilities are to study the debtor's financial behavior both past and present, to see that he makes full disclosure of his financial situation, to analyze his farm business, its financial strengths and weaknesses, and to decide whether a continuation of

19 Experienced attorneys indicate the number of effective reorganizations in bankruptcy to be very low (percentagewise). Most chapter 11 cases appear to be filed primarily to delay the inevitable. Sooner or later a Chapter 7 liquidation takes place.

20 This is the theory. In actual practice the committee tends to "do business" and in this fashion perhaps recover some of the money owed.

the business is economically feasible. If the business is no longer economically sound, their job is to recommend to the court that the debtor be moved from a Chapter 11 (reorganization) to a Chapter 7 (liquidation) proceeding, and that the property or business be liquidated.

Any person who serves on the creditor's committee (as well as the trustee appointed by the court) assumes a fiduciary capacity. He cannot (or should not) place any personal interest above that of the creditors in general. He cannot (or should not) take advantage of any inside information obtained as a result of his service on that committee. He cannot (or should not) enter into any business activity which could be adverse to the debtor's business.[20] Furthermore, he should probably resist entering into any agreement to provide further services to either the debtor or the creditor, as a vested interest is readily apparent.

Procrastination: Unfortunately, most creditors procrastinate. Many creditors or their attorneys are not cognizant of their rights and/or the modus operandi that is available. They often hesitate to become aggressive when the other party is facing financial difficulties and perhaps family and personal problems as well.

The debtor is typically an individual, whereas the creditor is typically a financial institution. The debtor's payments are transfers, not to the salaried employee, who has little at stake (personally), but to the lending institution. Right or wrong, very few outside parties have much concern for the financial institution, which always appears to have more money than the borrower. Seldom do the outside parties realize that the institution's funds consist of pledges and payments to depositors, stockholders, and/or investors who have bills of their own to pay.

The creditor and the debtor may enter into an agreement with regard to what will be done and when. Or, the creditor may wait until the case is either dismissed or closed and/or until a "discharge is granted." However, these decisions are not made by the court, unless the creditor(s) are requesting such in an aggressive fashion.

Debtor problems have come to be more and more 'accepted' by society today. The media in particular feel sorry for today's debtor. Publicity relative to a bankruptcy case has a tendency to have an adverse affect on the lender's image.

Liquidation may occur more often than is desired today. But when a debtor has defaulted on one or more loans, where he and/or his attorney has been reluctant to look at the problem immediately, and where interest accruals have increased the amount of any and all outstanding loans, there is no other alternative.[21]

A Chapter 11 Business Reorganization

The bankruptcy petition as it applies to the farmer typically requests a "stay" to allow that farmer-debtor to enter into a reorganization of his farming operations. The purpose is to show how the debtor plans to continue the business.

The plan should include a listing of all claims by creditors. These claims should be separated into classes--impaired and unimpaired, secured and unsecured, first, second, etc. priorities, and if the business is incorporated, stockholders' claims. The

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21 The farmer is sometimes the creditor rather than the debtor. In some instances a local elevator has mismanaged certain funds. If in bankruptcy it is then the farmer who is not paid what he was promised.

plan should show how each class is to be treated, and how all debts--principal amounts, interest, and any deficiencies--are to be paid.

The plan should show what crops and livestock will be raised, total crop production and feed requirements, the cash farm receipts, cash farm expenses, and the farm income that can be expected. The plan should show whether the farm can be operated on a profitable basis.

The debtor's income tax returns for the last several years are probably available. While they may show the problem--reduced receipts, increased expenses (mainly interest), etc.--they are not usually sufficient to project the future. Most farm tax returns are on a cash basis. They often include sales that have been delayed and expenses for subsequent years.

The Traditional Farm Plan: A farm plan showing the typical crop and livestock enterprises, the farm receipts that can be expected, and the farm operating expenses under a typical operator is needed. A cash flow sheet showing when various farm receipts will become available, when various farm expenses will have to be paid, and whether there is sufficient cash flow to make the principal and interest payments is required.

This plan or projection needs to be based on the typical farm price-cost relationships that have existed during the last 5 or 10 years and those which one can expect to be in existence in the near future. Average farm prices received by all farmers, along with a comparable set of farm costs during the same period, should be used. Any long term trend or cyclical tendency, for example the tendency for cattle or hog prices to go move up and down, should be considered. The income projection cannot be conjectural. The plan should show how that income is to be obtained.

Loan payments are generally fixed in amount. But not always. If some are variable then one or more alternative budgets--one based on an expected rate of interest, and then several showing the results with each change (increase or decrease) of 1.0 percent in the rate of interest--need to be prepared.

The Final Decision

The real question facing every creditor's committee, trustee, court or judge in a Chapter 11 bankruptcy is whether there is any reorganization plan that will "save" the debtor and provide the income required to pay all of his restructured debts over a given period of time. The creditor's committee, like the bankruptcy judge, is faced with some "very hard" decisions. Some of the questions are basic, for example, what does the debtor's financial statement show? Some require considerable study, for example, is the projected income realistic?[22] Some are conjectural, for example, what does the future hold?

Three Difficult Questions: Eventually at least one of three economic questions has to be answered.

One:--Is the residual income (based on a reorganization of the business) equal to or larger than the principal and interest payments? Residual income is the amount that remains after paying all farm operating expenses, any income taxes that may be due, the farm family's living expenses and hopefully capital replacement. The loan payment generally refer to all principal and interest. In some instances, they include interest accruals and/or principal payments in

22 In these situtations debtors and their attorneys tend to be very optimistic about future crop yields, rates of livestock production, and farm prices.

arrears. These latter are referred to as deficiencies.

Two:--If the income is not equal to or larger than the loan payments, is the present market value of all assets equal to or larger than the total of all loans outstanding? Present market value is what the property or collateral will most likely sell for on today's market. That value (particularly if the security consists of real estate) should be based on a professional appraisal.[23] The value of all outstanding loans consists of all remaining balances. Payments in arrears and interest accruals are included, along with all appraisal fees, attorney fees, court costs, and administrative expense relative to the proceedings.

Three:--Is the value of the property likely to increase in the future and, if so, to the extent that the increase will be equal to or greater than (a) the negative net worth (liabilities over assets and/or (b) the deficiencies in the loan payments (over and above the income)?

Some debtors may claim to be in difficulty due to the decline in farm land values. They often contend that these values could turn around and increase again in the next five to ten years. This is a very difficult prediction, in fact somewhat conjectural. One only needs to study a set of financial tables and the concept of compound interest to realize that the increase in value is not very likely to cover the costs enroute. And furthermore, the debtor's liabilities relative to his interest payments continue, regardless of what happens to land values.

Thus, the creditor's committee, trustee, and/or judge is faced with the question as to whether the debtor's present situation is a temporary one or whether it reflects a permanent-type problem and/or whether additional time (continued delay) will solve the problem.

Judges and others need to be reminded that a high percentage of reorganizations become liquidations sooner or later. The sooner an inevitable decision is made, the earlier the creditor can go about his business, the earlier the debtor can start over with a new economic life, and the lower the costs, both in terms of dollars (court costs and attorney fees) and time, trouble, and frustration.

They are also faced with the question as to whether the debtor has the managerial ability and/or the willingness to cope with whatever financial difficulties he faces. (Most parties agree that the lack of managerial ability is the fundamental problem.) A detailed set of farm records, along with a budget of all projected receipts and expenses (sometimes with a built-in 30-day time-lag required before each expenditure is made), is required. Many farmers are not this "record-keeping" oriented, but this is required.

<u>Acceptance or Rejection of the Plan:</u> During the automatic stay there are many provisions above and beyond the one which prevents a creditor from enforcing his lien. For example, relief from the stay may be granted when:

1. A creditor is able to show that the debtor has no equity whatsoever in the property and that the property is not needed for the reorganization of the business. For ex-

23 Present market value should be ascertained first, always, and regardless of whether the appraisal is for the debtor or the creditor. After ascertaining that market value the question of a liquidation price may need to be discussed. A liquidation price can be 10 to 25 percent (or more) below present market value.

ample, a farmer may own a motor home, a boat, a snowmobile, or some other property which is not really needed in the continuation of his business. In this situation, a creditor may argue that the debtor's business can be reorganized effectively without his collateral.

2. A creditor may also attempt to show that he does not have adequate financial protection. He may attempt to show (a) that the periodic cash payments will not equal a probable decline in the value of the collateral, (b) that he is not being provided with a replacement lien or other collateral, and/or (c) that he will not receive, without any doubt, the equivalent of his collateral or property.

Acceptance of a plan requires approval by the majority of the creditors and by representatives of at least 2/3rds of the dollar amounts held by the impaired creditors in each class.

Every impaired creditor is protected by the code in that he has to receive an amount equal to whatever amount he would receive under a Chapter 7 liquidation. However, any impaired creditor may still object. The debtor may object. Furthermore, if the plan is not accepted by the creditors the debtor can insist upon acceptance as long as the plan is fair or equitable with respect to each class of impaired creditors (even those who have not accepted the plan). This forced acceptance is referred to as the Code's "cram-down provision."

A given plan or reorganization may be confirmed over the objection of a secured creditor. This can occur only if the plan allows the collateral or property to be sold (free and clear of the creditor's lien) with the lien then attaching to the proceeds of the sale. Or, the plan must allow the creditor to retain his lien and continue receiving cash payments equal to whatever collateral or property is held by him. In other words, the plan can be confirmed over the objection of a creditor, one way or another, but only if the creditor receives, without any doubt, the equivalent of his claim.

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Farmers, bankers, and others could perhaps avoid both insolvency and bankruptcy problems by recognizing more fully the obligations that each party accepts when they agree to a farm loan. That loan and the subsequent investment should be one which will pay in the future, even when the future holds some risks. Realistic values on collateral and cash flow analyses showing sufficient farm earnings to do whatever the loan is intended to accomplish are required. Only in this fashion can the farm family and other members of the agricultural community avoid the unhappy experiences that accompany insolvency and bankruptcy.

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